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IN THE

Supreme Court of the United States

October Term, 1979
No. 79-1251

HARRIS, KERR, FORSTER AND COMPANY,

Petitioner,

vs.

SPECTRUM FINANCIAL COMPANIES, KENNETH B. BONILLA, ALLEN L. BARBIERI, JAMES E. NEVITT, *et al.*,

Respondents.

Opposition to Petition for Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

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Questions Presented.

1. Respondent takes exception to Petitioner's characterization of the nature of the legal issues sought to be reviewed. The facts in this action are such that the trier of fact might properly find that HKF was not only "reckless," but also acted with full knowledge of the impropriety of its conduct.

2. Respondent also takes exception to Petitioner's characterization of the opinion of the Ninth Circuit Court of Appeals in the instant case as a decision which construed the standard of "recklessness" in a manner such as to sanction liability for "merely negligent conduct." It is submitted that after *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Ninth Circuit has consistently held that negligence is not sufficient to establish liability in a 10b-5 action.

3. Finally, Respondent takes exception to Petitioner's conclusion that the Ninth Circuit's "flexible duty" approach, as set forth in *White v. Abrams,* has been applied in the instant case as either a substitute or alternative for the scienter requirement. It is submitted that the Ninth Circuit is not using the "flexible duty" approach as a substitute or an alternative for the scienter requirement established by *Hochfelder.*

Statement of the Case.

Respondent feels constrained to comment upon Petitioner's version of the "facts" in the case at bar, particularly in light of the fact that this case comes to this Court as a result of a reversal of the trial court's granting of summary judgment in favor of Petitioner.

Petitioner's brief states that Marconsult, Inc. (hereinafter "Marconsult"), around whose fortunes the case turns, "was consistently cash-poor and did not prosper." (Petition, page 3). At best, this may be viewed as an understatement. Marconsult was, for all practical purposes, completely defunct (CT 1008-1020).

The Petitioner's brief also asserts that the exchange of Respondent's oil and gas interests for Marconsult's securities was approved by the limited partners in Spectrum Leveraged Natural Gas I and II (hereinafter "SLNG I and II"), without reliance on the sixteen-month report prepared by the Petitioners (Petition, page 7). This ignores the fact that the transaction was expressly conditioned upon the approval of the California Commissioner of Corporations (CT 953, lines 23-26). Thus, the partners of SLNG I and II relied upon the expertise of the California Commissioner of Corporations, who in turn relied upon the sixteen-month statement prepared by HKF (CT 1074).

The Petitioner's brief also asserts that the limited partners in SLNG I and II were "high-income individuals" who invested in the partnership for the "primary purpose of obtaining tax shelter." There are no facts of record to support such statements, and they are entirely irrelevant to the issues herein.

The Petitioner also states that its second motion for summary judgment was granted because "the complaint raised no triable issue of fact regarding scienter as required by *Hochfelder* . . ." (Petition, page 9). Inasmuch as the district court granted the motion without opinion, it is submitted that Petitioner has overstepped its bounds by supplying the district court with such purported grounds.

Rather than further comparing at length the "facts" presented by Petitioner with those established by Respondent in its opposition to Petitioner's motion for summary judgment, Respondents submit that the following are, in reality, the genuine "material facts" which created the "genuine issues" for purposes of the summary judgment motion decided by the trial court in the instant case.

The salient facts, as they pertain to the substantive issues, disclose that in early January of 1972, the general partner of two limited partnerships, SLNG I and II entered into an agreement with Marconsult, Inc. (Pretrial Conference Order, section III, "Admitted Facts" CT 953), pursuant to which the limited partners of the limited partnerships agreed to exchange their respective limited partnership interests in certain producing oil and gas wells for common stock and debentures by Marconsult, Inc. (CT 953, lines 10-14). This agreement was conditioned upon the approval of at least

75% of the limited partner of each partnership and the approval of the California Commissioner of Corporations (CT 953, lines 23-26).

In March, 1972, HKF was hired by Marconsult to conduct an audit of Marconsult's financial condition for the calendar year 1971 (CT 953, lines 27-31). During the course of this audit HKF gained the knowledge of the pending exchange and the pending hearing before the California Commission of Corporations (CT 1004, lines 4-11) and knew that the financial condition of Marconsult was a substantial and important factor that would be considered by both the limited partners and the California Commissioner of Corporations in determining whether the exchange would go forward (CT 1005, line 22 through CT 1006, line 3; CT 1007, lines 5-14).

On May 8, 1972, HKF delivered to Marconsult draft copies of Marconsult's financial statements for the calendar year 1971 (the "twelve month statement") together with its audit report dated April 24, 1972, in which HKF stated that the financial statements had been prepared in accordance with generally accepted accounting principles, consistently applied (CT 1036, 1038) subject only to certain qualifications with reference to certain research and development items and foreign investments which HKF could not verify (CT 1038, 1044).

This twelve month financial statement disclosed that Marconsult had only approximately $57,000.00 in sales during the entire calendar year 1971 (CT 1042) and had suffered a loss of approximately $245,604.00 during that calendar year (CT 1042). Marconsult concealed the existence of the twelve-month financial statement and rather than distributing it to the general

and limited partners or filing it with the California Commissioner in support of its application of permit for approval of the proposed exchange, requested HKF to certify new financial statements covering a sixteen-month period from August 31, 1970 to December 31, 1979 (CT 954, lines 19-22 [Pretrial Order—Section 3 "Admitted Facts," para. 13]).

In response to this request, HKF prepared the sixteen-month statement, to which it attached a certification substantially identical to the certification which it previously prepared in connection with the twelve-month statement (CT 1056-1058).

This sixteen-month statement was delivered by HKF to Marconsult between July 5, 1972 and July 14, 1972 (CT 1073) and was then delivered by Marconsult to both the general and limited partners of the limited partnerships (CT 772-773) and was filed with the California Commissioner of Corporations in support of Marconsult's application to issue freely tradeable common stock and debentures to the limited partners in exchange for the limited partnerships' interest in the oil and gas wells (CT 1074). The sixteen-month statement totally distorted the true financial condition of Marconsult and was not useful for any purpose other than as a attempt to confuse the reader as to Marconsult's financial condition (CT 1068). Among other things, this financial statement incorporated more than $200,000.00 of business conducted by Marconsult during the four-month "stub period" (CT 791) which was not included in the previously prepared twelve-month financial statement (CT 1042) (The four-month "stub period" incorporated in the sixteen-month statement was a period prior to the period covered by the twelve-month statement).

During the course of the audit HKF discovered that Marconsult was insolvent; had a negative net worth (CT 1012, lines 2-12); had consistently lost money (CT 1008); was unable to pay its bills or the salaries of its employees (CT 1015, 1020) and had effectively gone out of business.

Respondents contend that HKF misrepresented the true financial condition of Marconsult by stating, in the audit report which accompanied Marconsult's sixteen-month statement, that the financial statements had been prepared in accordance with generally accepted accounting principles, consistently applied, and by failing to prominently and unequivocally state in its audit letter that it could not render an opinion with respect to the company's financial statements because Marconsult was not a going business concern, was hopelessly insolvent and was in imminent danger of collapse.

Respondents further contend that HKF, in its opinion letter, omitted the material fact that the sixteen-month financial statement was not, by its very nature, prepared in accordance with generally accepted accounting principles, consistently applied, and in its certification failed to advise the reader that Marconsult was not a going business concern, and was, in effect, defunct.

HKF delivered Marconsult's sixteen-month financial statement, with the accompanying audit report, to Marconsult sometime between July 6, 1972 and July 14, 1972 (CT 772).

Sometime between July 6, 1972 and July 14, 1972, Marconsult mailed the sixteen-month financial statement and HKF's audit report thereon, to Spectrum's Limited Partners (CT 1067-1069). The twelve-month financial

statement with the audit report by HKF affixed thereto, was never distributed to Spectrum, the Department of Corporations, or Spectrum's Limited Partners.

On July 20, 1972, Marconsult filed an "Application for Removal of Condition on Shares of Common Stock" with the California Department of Corporations. This application was required in order to fulfill the condition precedent to the Marconsult/Spectrum exchange that Spectrum's Limited Partners were to receive freely tradeable stock (CT 1034). On August 17, 1972, after receiving HKF's opinion with respect to the sixteen-month financial statement of Marconsult, the California Department of Corporations removed the condition previously imposed by it upon the free tradeability of Marconsult stock to be received by Spectrum's Limited Partners (CT 1007).

REASONS FOR DENYING THE WRIT.

I

ALL OF THE COURTS OF APPEAL ARE IN AGREEMENT ON THE INTERPRETATION OF ERNST & ERNST v. HOCHFELDER.

A. There Is No Conflict Among the Courts of Appeal.

Petitioner has made the sweeping statement that "the eye of the needle in *Hochfelder's* footnote 12 now readily accommodates camels of all sizes, so long as they are labeled 'recklessness' " (Petition, page 12). This lyrical assertion is then "supported" by lengthy citations which Petitioner suggests distort the holding of *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976). However, a closer reading of the cited cases discloses that they have each carefully followed *Hochfelder* and have required a finding of "recklessness" to establish *10b-5* liability.

In *Sundstrand v. Sun Chemical Corp.,* 553 F.2d 1033, 1044 (7th Cir. 1977), *cert. denied,* 434 U.S. 875 (1977), the court held that "A reckless omission of material facts upon which the plaintiff put justifiable reliance in connection with a sale or purchase of securities is actionable under Section 10(b) as fleshed out by rule 10b-5." The Seventh Circuit has defined "recklessness" by reference to the definition in *Franke v. Mid-Western Oklahoma Development Authority,* 428 F.Supp. 719 (W.D. Okla. 1976), as "the functional equivalent of intent." 553 F.2d at 1045. This definition was further clarified in *Sanders v. John Nuveen & Co., Inc.,* 554 F.2d 790, 793 (7th Cir. 1977), in which the court held, "We believe 'reckless' in these circumstances comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence. We perceive it to be not just a difference in degree, but also in kind." Certainly this definition falls within *Hochfelder's* scope of scienter since it is expressly closer to intent than it is to negligence.

In *First Virginia Bankshares v. Benson,* 559 F.2d 1307, 1314 (5th Cir. 1977), *cert. denied,* 435 U.S. 952 (1978), the Fifth Circuit ruled in a manner consistent with *Hochfelder,* and held that the defendant must "know of the falsity of the information, or must act in reckless disregard of its falsity, or must intend to deceive." This definition is squarely in line with the *Hochfelder* requirement of "knowing or intentional misconduct." 425 U.S. 185, 197 (1976).

The Third Circuit, in *Coleco Industries, Inc. v. Berman,* 567 F.2d 569, 574 (3d Cir. 1977), *cert. denied,* 439 U.S. 830 (1978), defined scienter in 10b-5 actions as a conscious deception or a misrepresentation so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception. This definition also clearly squares with *Hochfelder.*

Petitioner has characterized *Rolf v. Blyth, Eastman Dillon & Co., Inc.,* 570 F.2d 38 (2d Cir. 1978) *cert. denied,* 439 U.S. 1039 (1978) as a " 'sliding scale' approach to scienter" (Petition, page 12, n. 7), because the case limits its acceptance of recklessness only to some situations. *Rolf* involved an aider/abettor situation where the aider/abettor owed a fiduciary duty to the defrauded party. Rather than being a loose "sliding scale" test of liability as Petitioner suggests, *Rolf* involves a strict definition of recklessness as scienter in some circumstances. This is completely in accord with footnote 12 in *Hochfelder,* 425 U.S. at 193-194, n. 12. Furthermore, *Rolf* analyzed the *Hochfelder*

decision at length before accepting reckless conduct as scienter. Clearly, this is an attempt to comply with *Hochfelder* to the letter, rather than an attempt to vitiate it. *Rolf* at 44-47.

Petitioner would have this court believe that in *Mansbach v. Prescott, Ball and Turben*, 598 F.2d 1017 (6th Cir. 1979), the Sixth Circuit has gone so far as to expressly limit *Hochfelder* (Petition, page 13, n. 8). The portion of the opinion quoted by Petitioner is taken out of context. After observing that a rule 10b-5 action is to be liberally construed to effectuate the policies of the Federal Securities Laws, the Sixth Circuit states:

> In line with that rule of construction, we should construe the §10/Rule 10b-5 claim no more narrowly than required by *Hochfelder*.[32] Requiring a plaintiff to show that defendant acted with actual subjective intent to defraud could impose a great burden upon recovery, greatly limiting the §10b/Rule 10b-5 claim. We believe that *Hochfelder* should be read to go no further than its specific holding that mere negligence is not enough for liability.

Id. at 1024-1025. Footnote 32 explains "the narrowing construction in *Hochfelder* was not adopted as a policy matter but was seen as mandated by the relevant statutory language. 425 U.S. at 214, 96 S.Ct. 1375."

Moreover, rather than refraining from defining recklessness as Petitioner claims, (Petition, page 14, n. 9), *Mansbach* affirmatively adopts the Seventh Circuit definition, 598 F.2d at 1025.

Hoffman v. Estabrook & Co., Inc., 587 F.2d 509, 516 (1st Cir. 1978), is also misunderstood by Petitioner. Rather than defining recklessness as "carelessness approaching indifference" as Petitioner asserts (Petition, page 14) the First Circuit expressly refrains from deciding whether recklessness, as well as fraud, will ground an action under rule 10b-5. *Id.* Petitioner's quoted language is that of the district court. The court of appeals by-passed the district court's definition as unimportant since the evidence did not establish reckless conduct in any event. Moreover, the appellate court reaffirmed its definition of recklessness as laid down in *Cook v. Avien, Inc.*, 573 F.2d 685, 692 (1st Cir. 1978), that "[Reckless conduct] comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence." *Id.* This definition is identical to the one used in the Sixth and Seventh Circuits.

In criticizing *Nelson v. Serwold*, 576 F.2d 1332 (9th Cir. 1978), *cert. denied*, 439 U.S. 970 (1978), the Petitioner has maligned the opinion unfairly. Rather than rashly broadening the scope of permissible 10b-5 actions as limited by *Hochfelder*, the Ninth Circuit undertook a scholarly judicial examination of that case. The opinion notes that Justice Powell accepted knowledge as well as intent by proscribing "knowing or intended misconduct," and further held that this Court strongly disagreed with the Securities and Exchange Commission argument that "Congress must have intended to bar all such practices and not just those done *knowingly* or intentionally" in making its decision. *Id.* 1337 (emphasis in original).

The *Nelson* court observed that *Hochfelder* cited no case or commentary indicating a requirement of strict common law intent. Further, the *Nelson* court reviewed the decisions of other circuits and, after determining that several had accepted recklessness as the

equivalent of scienter, decided to follow that path. *Id.* 1337.

Lastly, a brief word must be said about Petitioner's statement that the various circuits have "either refrained from defining 'recklessness' . . . or done so in either impossibly vague terms or terms which bear strong resemblance to ordinary negligence" (Petition, page 14, n. 9). To the contrary, the circuits have at times gone to great lengths to define "recklessness." ***See, e.g., Hoffman v. Estabrook & Co., Inc.***, 587 F.2d at 516.

Although Petitioner has attempted to argue that recent decisions of the circuit courts have eroded *Hochfelder*, it is clear that such is not the case. Moreover, since all of the circuits which have decided the issue are in accord regarding the interpretation of the rule 10b-5 scienter requirement, there is no need for this Court to grant certiorari. U.S. Sup. Ct. Rule 19(1)(b), 28 U.S.C.

B. The Interpretation of the Scienter Requirement by the Circuit Courts Is Correct and Proper.

As outlined in subpart A above, all of the circuit courts which have decided the issue are in agreement that the scienter requirement of *Hochfelder* is satisfied by proof of reckless conduct. These Respondents respectfully submit that the interpretation of the circuit courts is a correct and proper one under *Hochfelder*.

Neither the drafters of the Securities Exchange Act of 1934 nor this Court in *Hochfelder* intended to impose a more stringent standard for "scienter" than that imposed by the common law. It is clear that the 1934 Act was intended to provide more liberal remedies than permitted under the common law.

Historically, common law principles of deceit have their origin in *Derry v. Peek*, 14 A. 337 (1889). There the court dealt with liability for misrepresentation contained in a stock prospectus. The court held that while negligence was an insufficient basis for the imposition of common law liability for deceit, one who made a false statement while conscious that he had no sufficient basis to justify it or one who spoke with reckless disregard for the truth was liable in fraud. *See,* W. Prosser, *Torts* (4th Ed. 1971) at 700-701.

The issue of common law liability of an accountant who prepared a misleading financial statement was specifically considered in *Ultramares v. Touche,* 255 N.Y. 170, 174 N.E. 441 (1931). Mr. Justice Cardozo rejected negligence as a basis of liability, but recognized an important distinction between "innocent misrepresentation" and "willful reckless misrepresentation." *Id.*

Later courts reasoned that if reckless disregard for the truth was deemed culpable behavior in common law, logic dictated that the Federal Securities Laws were intended to embrace recklessness as well. *See, Trussell v. United Underwriters, Ltd.,* (D.C. Colo.) 228 F.Supp. 757, 772 (1964).

The issue of scienter in the area of misrepresentation is also discussed by Prosser:

> The intent which becomes important is the intent to deceive, to mislead, to convey a false impression. Obviously this intent, which has been given the name of 'scienter' by the courts, must be a matter of belief, that the representation is true; . . .
>
> There is of course no difficulty in finding the required intent to mislead where it appears that the speaker believes his statement to be false.

> Likewise there is general agreement that it is present when the representation is made without any belief as to its truth, *or with reckless disregard whether it be true or false.*

W. Prosser, *Torts* (4th Ed. 1971) at 700-701 (emphasis added).

Since the gravamen of both the tort of misrepresentation and the rule 10b-5 action lie in the intent to deceive, the above discussion is equally applicable in both areas.

Applying the common law and the position taken by Prosser to *Hochfelder* leads one to the conclusion that scienter must include reckless conduct. *Hochfelder* gives no sign that this Court meant to be more restrictive than the common law in defining scienter. Given the fact that the district courts were permitting recklessness to be used as a standard prior to *Hochfelder,* this Court must have recognized that recklessness would continue to be used as a standard. Thus, this Court has implicitly paved the way for the current "recklessness" standard used by the various circuits.

II

THE DECISION DOES NOT RESURRECT THE NEGLIGENCE STANDARD.

Petitioner has argued that the decision below resurrects the "negligence" standard (Petition, page 18). Petitioner argues that the Ninth Circuit has resurrected *White v. Abrams,* 495 F.2d 724 (9th Cir. 1974), and the "flexible duty negligence standard" as discussed in that case. This argument is without merit. The appellate court's discussion of *White v. Abrams* is fully consistent with this Court's holding in *Hochfelder. See, Spectrum Financial Companies v. Marconsult, Inc.,* 608 F.2d 377 (9th Cir. 1979).

The Ninth Circuit Court of Appeals noted that the district court granted the motion for summary judgment without benefit of its decision in *Nelson v. Serwold,* 576 F.2d 1332 (9th Cir. 1978), in which the Ninth Circuit adopted reckless behavior as sufficient for the scienter requirement. *Spectrum,* at 381. The court also noted that the district court judge did not indicate whether he examined the pleadings and depositions in light of a "recklessness" standard or required a stricter showing of intent and the court remanded for re-examination in light of *Nelson v. Serwold. Id.*

Only after thus deciding the case did the lower court begin any discussion of *White v. Abrams.* Clearly, that discussion was not the basis of the decision. Rather, the examination of whether Petitioner owed a duty to Respondent under *White v. Abrams* must be viewed as dictum, and did not impinge upon the criteria established in *Hochfelder.*

Petitioner has attempted to characterize the Ninth Circuit's decision in the instant case by labeling the duty requirement as "a substitute or alternative for scienter." (Petition, page 19). To the contrary, the lower court explained that the "duty to disclose" described in *White v. Abrams* presented an issue "*beyond* the issue of whether or not appellees were 'reckless' " (emphasis added) 608 F.2d at 381. Rather than diminishing the *Hochfelder* scienter requirement the lower court's decision has enlarged it by requiring not only a showing of reckless conduct, but an additional showing of duty. The burden upon plaintiffs in establishing 10b-5 liability is more strict, not less.

The lower court's decision does not need to be disturbed. Its discussion of *White v. Abrams* is merely dictum, and even if not, it strengthens, rather than weakens the *Hochfelder* scienter requirement.

III

THE INSTANT CASE IS NOT RIPE FOR REVIEW.

Petitioner has argued that even if "recklessness" suffices for scienter under rule 10b-5, nevertheless under no definition of recklessness could it be held liable (Petition, pages 14-17). We note that the Ninth Circuit reversed the order granting summary judgment, and remanded the instant action to the district court for consideration in light of *Nelson v. Serwold*. Furthermore, the rulings by the district court on Petitioner's motion for summary judgment were without opinion; Petitioner's assertion that the district court "found" that Respondents had failed to show that Petitioner had intended to deceive, manipulate or defraud, and that the district court "determined" that the action "could not proceed for lack of the element of scienter" (Petition, pages 14-15), are pure speculations and must be ignored. No such finding has been made. The case is now ready for the trier of fact to decide whether Petitioner was guilty of intentional misconduct, reckless misconduct, or merely negligent conduct.

Petitioner would have this Court decide at this time that a finding of either intent or recklessness is not possible. Certain "facts" have been asserted by Petitioner. Other opposing facts are, and have consistently been asserted by Respondent, which "facts" if proven may establish actual intent to defraud. Such factual determinations are for the trier of fact, not the appellate court. This case has been remanded to the district court in order that such factual determinations can be made.

Ripeness is basically a matter of timing. *See, Blanchette v. Connecticut General Insurance Corps.*, 419 U.S. 102 (1974). At the present time, this litigation does not present this Court with the concrete facts

that are necessary to an informed decision. When this case comes to trial, the trier of fact may very well find that Petitioner was guilty of intentional misconduct, in which case the question of recklessness would be moot. Conversely, the trier of fact may find Petitioner merely to be negligent, thus not liable, and again the recklessness issue would be rendered moot. Given these possibilities, this Court should not at this time undertake a review of this action. The Petition should be denied.

Conclusion.

Petitioner's petition for a writ of certiorari in the instant case should be denied. Petitioner has failed to show any grounds under the guidelines of Supreme Court Rule 19 upon which certiorari is appropriate. Various circuit courts, including the Ninth Circuit in this action, have addressed the issue of whether or not "recklessness" is sufficient to meet the "scienter" requirement in 10b-5 actions. All of these courts have concluded that "recklessness" is sufficient to state a cause of action under rule 10b-5. This result is entirely consistent with this Court's ruling in *Hochfelder*.

Additionally, this case is not yet ripe for review. The appellate court has ordered this action remanded to the district court for further findings of fact regarding the issue of "scienter." Therefore, Respondents respectfully submit that the petition for writ of certiorari should be denied.

Respectfully submitted,

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